

§413.153

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investment income on funded depreciation is not treated as a reduction of allowable interest expense under §413.153(a).

§413.153 Interest expense.

(a)(1) *Principle.* Necessary and proper interest on both current and capital indebtedness is an allowable cost. However, interest costs are not allowable if incurred as a result of—

(i) Judicial review by a Federal court (as described in §413.64(j));

(ii) An interest assessment on a determined overpayment (as described in §405.377 of this chapter); or

(iii) Interest on funds borrowed to repay an overpayment (as described in §413.64(j) or §405.378 of this chapter), up to the amount of the overpayment, unless the provider had made a prior commitment to borrow funds for other purposes (for example, capital improvements).

(2) *Exception.* In those cases of administrative or judicial reversal, interest paid on funds borrowed to repay an overpayment is an allowable cost, in accordance with this section.

(b) *Definitions*—(1) *Interest.* Interest is the cost incurred for the use of borrowed funds. Interest on current indebtedness is the cost incurred for funds borrowed for a relatively short term. This is usually for such purposes as working capital for normal operating expenses. Interest on capital indebtedness is the cost incurred for funds borrowed for capital purposes, such as acquisition of facilities and equipment, and capital improvements. Generally, loans for capital purposes are long-term loans.

(2) *Necessary.* Necessary interest is interest that meets the following requirements:

(i) It is incurred on a loan made to satisfy a financial need of the provider. Loans that result in excess funds or investments are not considered necessary.

(ii) It is incurred on a loan made for a purpose reasonably related to patient care.

(iii) It is reduced by investment income except income from—

(A) Gifts, grants, and endowments, whether held separately or pooled with other funds;

(B) Funded depreciation that meets the program's qualifying criteria;

(C) The provider's qualified pension funds;

(D) The provider's deferred compensation funds that meet the program's qualifying criteria; and

(E) The provider's self-insurance trust funds that meet the program's qualifying criteria.

(iv) It is not reduced by interest received as a result of judicial review by a Federal court (as described in §413.64(j)).

(3) *Proper.* Proper requires that interest be—

(i) Incurred at a rate not in excess of what a prudent borrower would have had to pay in the money market existing at the time the loan was made; and

(ii) Paid to a lender not related through control or ownership, or personal relationship to the borrowing organization. However, interest is allowable if paid on loans from the provider's donor-restricted funds, the funded depreciation account, or the provider's qualified pension fund.

(4) *Zero coupon bonds.* Zero coupon bonds are issued by government agencies, corporations, and banks at a price substantially below the face value. The difference between the purchase price and the face value reflects the actual amount of interest and is neither a discount nor an adjustment to the interest rate as with other bonds. Interest is paid at maturity when the bond is redeemed at face value.

(c) *Borrower-lender relationship.* (1) Except as described in paragraph (c)(2) of this section, to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower. Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in arm'slength transactions with lending institutions. The intent of this provision is to assure that loans are legitimate and needed, and that the interest

rate is reasonable. Thus, interest paid by the provider to partners, stockholders, or related organizations of the provider would not be allowable. If the owner uses his own funds in a business, it is reasonable to treat the funds as invested funds or capital, rather than borrowed funds. Therefore, if interest on loans by partners, stockholders, or related organizations is disallowed as a cost solely because of the relationship factor, the principal of such loans is treated as invested funds in the computation of the provider's equity capital under §413.157.

(2) Exceptions to the general rule regarding interest on loans from controlled sources of funds are made in the following circumstances. Interest on loans to providers by partners, stockholders, or related organizations made prior to July 1, 1966, is allowable as cost, provided that the terms and conditions of payment of such loans have been maintained in effect without modification subsequent to July 1, 1966. If the general fund of a provider "borrows" from a donor-restricted fund and pays interest to the restricted fund, this interest expense is an allowable cost. The same treatment is accorded interest paid by the general fund on money "borrowed" from the funded depreciation account of the provider or from the provider's qualified pension fund. In addition, if a provider operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost.

(3) If funded depreciation is used for purposes other than improvement, replacement, or expansion of facilities or equipment related to patient care, allowable interest expense is reduced to adjust for offsets not made in prior years for earnings on funded depreciation. A similar treatment is accorded deposits in the provider's qualified pension fund if such deposits are used for other than the purpose for which the fund was established.

(d) *Loans not reasonably related to patient care.* (1) The following types of loans are not considered to be for a purpose reasonably related to patient care:

(i) For loans made to finance acquisition of a facility, that portion of the cost that exceeds—

(A) Historical cost as determined under §413.134(b); or

(B) The cost basis determined under §413.134(g); and

(ii) Loans made to finance capital stock acquisitions, mergers, or consolidations for which revaluation of assets is not allowed under §413.134(k).

(2) In determining whether a loan was made for the purpose of acquiring a facility, we apply any owner's investment or funds first to the tangible assets, then to the intangible assets other than goodwill, and lastly to the goodwill. If the owner's investment or funds are not sufficient to cover the cost allowed for tangible assets, we apply funds borrowed to finance the acquisition to the portion of the allowed cost of the tangible assets not covered by the owner's investment, then to the intangible assets other than goodwill, and lastly to the goodwill. Repayments of the funds borrowed are applied first to the borrowing related to the tangible assets, then to the borrowing related to the intangible assets other than goodwill, and lastly to the borrowing related to the goodwill.

(3) When a provider borrows funds, but only some of the funds are necessary, repayments of the loan (principal and interest portions) are applied first to pay for the necessary portion of the loan. Only after all of the necessary portion of the loan (principal and interest) has been repaid are any repayments applied to the unnecessary portion of the loan. Repayments toward non-allowable borrowing pertaining to assets or activities not related to patient care are considered investments, and the provisions of paragraph (b)(2)(iii) of this section are applied.

(e) *Zero coupon bonds*—(1) *Interest on bonds issued on or after August 15, 1996.* For zero coupon bonds issued on or after August 15, 1996, interest expense incurred to provide funds for patient care-related costs is an allowable expense, and interest income earned for investment purposes is an allowable offset, in the cost reporting period in which the interest accrues.

(2) *Interest income offset.* Interest income from zero coupon bonds must be offset against allowable interest expense as prescribed in paragraph (b)(2)

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of this section and in § 413.130(g)(2). If zero coupon bonds are purchased with the proceeds of an advanced refunding of debt, offset of the investment income is required under § 413.153(b)(2)(iii), but the investment income is not prorated under § 413.130(g)(2).

(3) *Use of effective interest method.* (i) Interest expense and interest income from zero coupon bonds that are reported as they accrue must be amortized using the effective interest method. This method recognizes the actual accrual of interest expense or income for each interest computation period (as specified by the bond instrument) throughout the life of the bond.

(ii) A constant effective yield rate is determined and applied to the book value (outstanding loan balance including prior accrued interest) of the bond at the beginning of each period to determine the total interest for the period.

(iii) If the interest computation period involves portions of more than one cost reporting period, the amount of interest for that computation period shall be apportioned to each cost reporting period.

(iv) An example of the computation of interest using the effective interest method follows:

Facts

Life of zero coupon bond: 15 years.

Value at maturity: \$50,000.

Bondholder pays \$6,996 for the bond.

Annual interest rate is 13.5506% compounded semi-annually.

From the table below, interest for the first year would be \$980.11 (\$474.00 plus \$506.11).

Col 1 Six-month periods	Col 2 Book value beginning of period	Col. 3 Effective interest*	Col. 4 Book value end of period (columns 2 + 3)
1	\$6,996.00	\$474.00	\$7,470.00
2	7,470.00	506.11	7,976.11
3	7,976.11	540.40	8,516.51
4	8,516.51	577.02	9,093.53
29	43,855.94	2,971.37	46,827.31
30	46,827.31	3,172.69	50,000.00

*Computed by multiplying the book value at the beginning of each period (Column 2) by 6.7753% (the annual interest rate of 13.5506% \div 2 = 6.7753%).

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§ 413.157 Return on equity capital of proprietary providers.

(a) *Definitions.* For purposes of this section—

Proprietary provider means a provider that is organized and operated with the expectation of earning a profit for its owners (as distinguished from a provider that is organized and operated on a nonprofit basis). Proprietary providers may be sole proprietorships, partnerships, or corporations. Effective for cost reporting periods beginning on or after July 6, 1987, the term applies only to proprietary hospitals and SNFs.

(b) *General rule.* A reasonable return on equity capital invested and used in the provision of patient care is paid as an allowance in addition to the reasonable cost of covered services furnished to beneficiaries by proprietary providers.

(1) *Rate of return applicable to proprietary providers for cost reporting periods beginning before July 6, 1987.* Except as provided in paragraphs (b)(2), (b)(3), and (b)(4) of this section, the amount allowable on an annual basis, for cost reporting periods beginning before July 6, 1987, is determined by multiplying the provider's equity capital by a percentage equal to one and one-half times the average of the rates of interest on special issues of public debt obligations issued for purchase by the Medicare Part A Trust Fund for each of the months during the provider's reporting period or portion thereof covered under the program.

(2) *Rate of return for inpatient hospital services furnished by proprietary hospitals.* The rate used in determining the return for inpatient hospital services is a percentage of the average of the rates of interest described in paragraph (b)(1) of this section. The percentages applicable to inpatient hospital services are as follows:

(i) 150 percent for cost reporting periods beginning before April 20, 1983.

(ii) 100 percent for cost reporting periods beginning on or after April 20, 1983 and before October 1, 1986.